United States Court of Appeals

for the Second Circuit

APPELLANT'S BRIEF

76-7577

IN THE

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

No. 76-7577

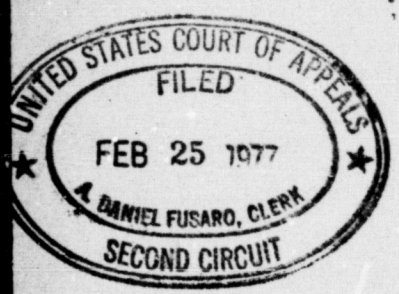
DONALD KATZ, Trustee in Bankruptcy of Oakland Foundry Company of Belleville, Illinois, Inc.,
Plaintiff-Appellant,

vs.

FIRST NATIONAL BANK OF GLEN HEAD,
Defendant-Appellee.

On Appeal from the United States District Court for the Eastern District of New York

BRIEF OF PLAINTIFF-APPELLANT



JOEL A. KUNIN
DAVID J. LETVIN
COHN, CARR, KOREIN, KUNIN and BRENNAN
412 Missouri Avenue
East St. Louis, Illinois 62201
(618) 274-0434
Attorneys for Plaintiff-Appellant

and

MURRAY S. LUBITZ
KAZLOW and KAZLOW
111 Brook Street
Scarsdale, New York 10583
(914) 723-5300
Attorneys for Plaintiff-Appellant

St. Louis Law Printing Co., Inc., 812 Olive Street 63101 314-231-4477

TABLE OF CONTENTS

Table of Cases

STATUTES

11 U.S.C. §96. Preferred creditors:

(a) (1) A preference is a transfer, as defined in this title, of any of the property of a debtor to or for the benefit of a creditor for or on account of an antecedent debt, made or suffered by such debtor while insolvent and within four months before the filing by or against him of the petition initiating a proceeding under this title, the effect of which transfer will be to enable such creditor to obtain a greater percentage of his debt than some other creditor of the same class.

(2) For the purposes of subdivisions (a) and (b) of this section, a transfer of property other than real property shall be deemed to have been made or suffered at the time when it became so far perfected that no subsequent lien upon such property obtainable by legal or equitable proceedings on a simple contract could become superior to the rights of the transferee. A transfer of real property shall be deemed to have been made or suffered when it became so far perfected that no subsequent bona fide purchase from the debtor could create rights in such property superior to the rights of the transferee. If any transfer of real property is not so perfected against a bona fide purchase, or if any transfer of other property is not so perfected against such liens by legal or equitable proceedings prior to the filing of a petition initiating a proceeding under this title, it shall be deemed to have been made immediately before the filing of the petition. * * *

(b) Any such preference may be avoided by the trustee if the creditor receiving it or to be benefited thereby or his agent acting with reference thereto has, at the time when the transfer is made, reasonable cause to believe that the debtor is insolvent. Where the preference is voidable, the trustee may

recover the property or, if it has been converted, its value from any person who has received or converted such property, except a bona fide purchaser from or lienor of the debtor's transferee for a present fair equivalent value: **Provided, however,** That where such purchaser or lienor has given less than such value, he shall nevertheless have a lien upon such property, but only to the extent of the consideration actually given by him. Where a preference by way of lien or security title is voidable, the court may on due notice order such lien or title to be preserved for the benefit of the estate, in which event such lien or title shall pass to the trustee. For the purpose of any recovery or avoidance under this section, where plenary proceedings are necessary, any State court, which would have had jurisdiction if bankruptcy had not intervened and any court of bankruptcy shall have concurrent jurisdiction. * * *

IN THE

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

No. 76-7577

DONALD KATZ, Trustee in Bankruptcy of Oakland Foundry Company of Belleville, Illinois, Inc.,
Plaintiff-Appellant,

vs.

FIRST NATIONAL BANK OF GLEN HEAD,
Defendant-Appellee.

On Appeal from the United States District Court for the Eastern District of New York

---

BRIEF OF PLAINTIFF-APPELLANT

PRELIMINARY STATEMENT

This cause was decided in the United States District Court for the Eastern District of New York by the Honorable George C. Pratt. The case has not been reported, but a summary thereof appears in CCH Bankruptcy Law Reporter ¶ 66,168 (1976).

ISSUES

The issues before the Court are:

(1) In determining whether a bank's set off of its debtor-depositor's account is a voidable preferential transfer within the

Bankruptcy Act, do the Courts look exclusively to the ordinary course of the Bank's business, or may they look to the ordinary course of the depositor's business, the ordinary course of the Bank's business, and the ordinary course of transactions between the depositor and the Bank?

(2) Whether under either the test applied by the Trial Court (looking only to the Bank's ordinary course of business) or the test requiring examination of the Bankrupt's ordinary course of business, the Court erred in concluding that no issue of material fact is presented by this case?

STATEMENT OF THE CASE

Plaintiff, Donald Katz, Trustee in Bankruptcy of Oakland Foundry Company of Belleville, Illinois, Inc., brought this action to set aside, as a voidable preference, a set off of $108,783.91 from the bankrupt's account by the defendant, First National Bank of Glen Head pursuant to § 60 of the Bankruptcy Act, 11 U.S.C. § 96. It was the gravamen of the Complaint that the $108,741.07 deposited by the Bankrupt into its previously inactive bank account, which sum was deposited during the 2½ months immediately preceding bankruptcy, was intended as a preferential payment of an outstanding indebtedness of the Bankrupt, which indebtedness was personally guaranteed and secured by the Bankrupt's President and owner. The District Court, Judge Pratt of the Eastern District of New York, allowed the bank's Motion for Summary Judgment. The Trustee appeals from this grant of Summary Judgment.

This Court's jurisdiction is derived from 28 U.S.C. § 1291 and 28 U.S.C. § 1294(1).

STATEMENT OF FACTS

Oakland Foundry Company of Belleville, Illinois, Inc., the Bankrupt, was a wholly-owned subsidiary of Electronic Cabinets, Inc. (A. 193, 194). All the stock of Electronic Cabinets, Inc., as well as all of the stock of H. W. Brede Co., Inc., was owned by Herman Brede and his wife, Betty, of Upper Brookville, New York (A. 193). Brede was the President and Chief Executive Officer of Oakland Foundry (A. 187).

Oakland maintained two checking accounts at the St. Clair National Bank of Belleville, Illinois, one checking account at the Trade Bank and Trust Company of New York (not pertinent to these issues), and one checking account at First National Bank of Glen Head, New York, which was opened on January 16, 1969 (A. 189, 190).

The Loan Transaction.

In consideration of a loan in the amount of $125,000.00, Oakland Foundry executed a Promissory Note in like amount in favor of First National Bank of Glen Head. This Note was executed on or about January 16, 1969, and matured on April 16, 1969. The Note was renewed quarterly until June 18, 1970, at which time Oakland's obligation was made payable on demand (A. 25).

The Bank ordinarily required a personal Guarantee on corporate borrowings by small individually held corporations such as Oakland. In this instance, at the time the loan was made, Electronic Cabinets, Inc., Herman Brede and Betty Brede, each guaranteed Oakland's indebtedness to the bank. Without the personal guarantee of the Bredes, the Bank would not have made the $125,000.00 loan to Oakland (A. 25).

Oakland's indebtedness to the Bank was further secured by a pledge to the Bank by the Bredes of all of the stock of Electronic Cabinets, Inc. and all of the stock of H. W. Brede Company, Inc. (A. 25, 188).

On June 18, 1970, when Oakland's indebtedness was converted to a demand Note, as additional security on the loan, the Bredes gave the Bank a Second Mortgage on their Upper Brookville, New York, home (Doc. No. 33, Exhibit D) (A. 26, 51, 52, 76).

On January 16, 1969, the same day that the Bank loaned Oakland $125,000.00, and pursuant to the Bank's usual practice, Oakland opened a general checking account with the Bank (Doc. No. 33, Exhibit E) (A. 26, 50, 51).

The Bank's Knowledge of Oakland's Financial Difficulties.

Before the Bank made the loan to Oakland, it was aware of the company's financial problems. It expressed concern that Oakland had turned only losses for the eleven months preceding the loan, and instead of loaning Oakland $250,000.00, as requested, loaned it only $125,000.00 (A. 62, 63). The loan was made not on the strength of Oakland's capacity to repay it, but on Brede's individual financial strength apart from Oakland Foundry (A. 64, 65).

During the 2½ years following the loan and before Oakland's bankruptcy in July of 1971, the Bank continued its awareness of Oakland's financial straits. Anthony Famighetti, at all times here pertinent, the President of the First National Bank of Glen Head (A. 44, 45) testified that he knew that Oakland was having difficulties as early as 1970 (A. 108), and that he knew that Oakland had been operating for years on a continuing loss basis (A. 109, 150). Indeed, the reason the Bank required additional collateral from Oakland was because it knew that Oakland had

not earned a profit during the several years prior to its 1971 bankruptcy (A. 115). In June of 1970, at the time the second mortgage was taken on Brede's home, Oakland had an accumulated deficit of $300,000.00 and had lost $100,000.00 in the prior calendar year (A. 78). In 1970, Famighetti was concerned about Oakland's cash flow, knew that Oakland owed $250,000.00 to the Small Business Administration, and had total debts too heavy for it to carry (A. 79, 80, 128, 129). The Bank knew that Oakland had obtained loans to the legal limit in 1970, from the St. Clair National Bank in Belleville, Illinois (A. 122, 125, 126) where Oakland maintained two checking accounts and did most of its banking. The Bank also knew that Oakland was financing its receivables through a factoring organization (A. 126, 127). The Loan Committee of The First National Bank of Glen Head, in 1970, discussed Oakland's financial situation and its low working capital (A. 130, 131) and knew of the low balance maintained in Oakland's Glen Head account (A. 132, 133). Famighetti admitted that the defendant became aware of Oakland's "adverse financial condition" as its financial statements, which reflected the loss history, were received by the Bank. Additionally, Famighetti stated that he felt that Oakland was always in an adverse financial condition. He stated, specifically, that he was aware of Oakland's losses for the years, 1968, 1969 and 1970 (A. 62, 63, 138, 139).

Although Oakland was regularly to supply the Bank with its financial statements, it took regular prodding from the Bank to get Brede to submit these reports (A. 69, 70, 71, 72, 74, 75).

The Bank had knowledge that Oakland gave false information in its Dun & Bradstreet Report for calendar 1970, the report representing sales of $1.4 million, and the income statement available to the Bank representing sales at only $546,000.00 (A. 156, 157, 162-165). The Dun & Bradstreet Report thus indicated sales in excess of 2.56 times the data available to the Bank.

In addition, Brede had been in close contact with the Bank respecting Oakland's obligation to the Bank during the few months immediately preceding the set-off (A. 16, 17), and the Bank had knowledge of Oakland's financial condition during those last few months as a result of discussions with Brede and one of Oakland's employees (A. 15). In 1970, aware that the St. Clair National Bank and the Small Business Administration were creditors of Oakland, the Bank began asking that a substantial "compensating balance" be maintained in the Oakland checking account. The reason the Bank's President gave for making such a demand was "to be sure that we weren't left out in the cold, since we were extending substantial dollars, too." (A. 88, 89, 132, 133).

The Ordinary Course of Business of Oakland and the First National Bank of Glen Head.

By March, 1971, Oakland had ceased normal, ordinary business operations.

Until February, 1971, Oakland regularly met its factory and office payrolls. In March, 1971, a much smaller factory payroll was met, and some back-payments were made on the factory payroll. In addition, a reduced office payroll was met that month. In April, 1971, no factory payroll whatsoever was reflected, and the reduced office payroll was met. By June, 1971, the office payroll was further reduced, and the factory payroll again was not evident. (Doc. No. 38, Exhibit C) (A. 11, 15).

Although the Bank has taken the position in this litigation, before the District Court, that the checking account which Oakland maintained with it was a general business account, Famighetti testified that the Bank was not aware of what types of obligations the checks on the Glen Head account and the St. Clair account were used to pay (A. 176, 12). In fact, virtually

all of the routine banking done by Oakland was done through its two accounts at St. Clair National Bank of Belleville.

The character of Oakland Foundry Company's "ordinary course" business transactions can best be understood by a study of activity in its three main bank checking accounts. Two of these checking accounts were with St. Clair National Bank of Belleville, Illinois. One was the Foundry's regular account (Doc. No. 38, Exhibit A), and the other was the Foundry's payroll account. (Doc. No. 38, Exhibit B). The St. Clair Bank was located within one mile of Oakland Foundry's place of business. The third account was that with the defendant, First National Bank of Glen Head, New York.

A review of the Transactions between Oakland and the First National Bank of Glen Head shows that from July of 1970, through March of 1971, a modest balance of between $1,300.00 and $5,800.00 was maintained in that account. Deposits were occasionally made, as were withdrawals, but by and large the account was inactive. In July no checks were drawn on this account. In August three checks were drawn. The records of September of 1970 through April of 1971, a period of eight months, reflect that the only activity in the Glen Head account consisted of the following:

1. A check from the Glen Head account, payable to Glen Head on October 15, 1970;

2. A withdrawal of $300.00 on November 20, 1970;

3. A deposit of $3,000.00 on January 25, 1971, and a simultaneous withdrawal payable to First National Bank of Glen Head for interest of $2,656.25 on January 25, 1971;

4. A deposit of $2,922.79 on March 8, 1971; and on April 13, 1971, a check in the amount of $2,656.25, payable to Glen Head for interest; and

5. On April 15, 1971, a check to Dun & Bradstreet in the amount of $792.40.

After charging Oakland's account with those last two checks, the balance was a meager $865.09 (Doc. No. 38, Exhibit B, and Exhibit C).

The Build-Up.

The pattern changes markedly on or about April 20, 1971. During the next two weeks enough deposits were made in the Glen Head account to bring the balance from $865.09 to $68,-603.65 by the end of April. In May of 1971, further deposits were made bringing the balance in the Glen Head account to $102,066.14. In June, eleven deposits were made in the Glen Head account bringing the balance therein to $109,348.66 according to records of Bankrupt. (Doc. No. 38, Exhibit C). (The statements furnished by defendant indicated a difference of approximately $600.00.) On the first of July, one final deposit was made into the Glen Head account, bringing the amount of money in the account (without considering the setoff by the Bank on June 30) to $109,597.16.

This final deposit was made *after* Brede's June 29 call to Famighetti in which Brede told Famighetti that Oakland was experiencing "complications" with its creditors (A. 171). This final deposit was also made *after* Famighetti ordered that payment was not to be made on checks drawn on Oakland's account.

Thus from April 15, 1971, when the balance was $865.09, in a period of 2½ months, a total of $108,732.07 was placed in the account. During that 2½ months, no withdrawals at all were made until the defendant set off the account in the amount of $108,783.91 on June 30.

The deposits which constituted the build-up were as follows (A. 10):

Date	Amount of Deposit
4/20/71	$ 2,546.63
4/21/71	2,071.00
4/26/71	43,120.93
4/28/71	20,000.00
5/04/71	4,681.76
5/07/71	668.81
5/18/71	21,451.01
5/25/71	1,303.47
5/28/71	5,357.44
6/01/71	484.94
6/05/71	1,588.68
6/07/71	668.83
6/09/71	982.05
6/14/71	898.68
6/10/71	9.70
6/21/71	820.17
6/25/71	1,157.50
6/29/71	88.22
6/22/71	19.00
6/30/71	564.75
7/01/71	248.50

Defendant takes the position that this account, on which no checks at all were written for 2½ months, was a regular checking account used for everyday business purposes. From January 1, 1971 to July 15, 1971, a period of six and one-half months, only three checks were drawn on the First National Bank of Glen Head by Oakland, and two of these were to pay interest to Glen Head on the outstanding obligations of the Bankrupt.

Oakland's Ordinary Course of Banking With St. Clair National Bank.

One need only view the Bankrupt's regular bank account (and not its payroll account) at the St. Clair National Bank of Belleville for the same period of time to see that virtually all of Oakland's routine business was processed through this account. A review of Document No. 38, Exhibit A, shows the following transactions:

	Number of Checks	Number of Deposits
July, 1970	149	16
August, 1970	58	8
September, 1970	118	11
October, 1970	78	17
November, 1970	120	17
December, 1970	65	8
January, 1971	43	8
February, 1971	112	10
March, 1971	66	10
April, 1971	49	6
May, 1971	33	1
Total	891	112

These checks were drawn for the purpose of paying payables, transfer funds for payroll to the payroll account (Document No. 38, Exhibit B), taxes, operating expenses and other items connected with the "ordinary" operation of Bankrupt's business.

The Set-off.

Oakland's President, Herman Brede, testified he was depositing the large sums into First National "because several of the

creditors (of Oakland) were trying to attach the funds in (the) St. Clair (account)." The District Court adopted this reasoning, stating that for purposes of deciding the Bank's Motion for Summary Judgment, he assumed that the deposits were made to "isolate funds from its [Oakland's] creditors, or to place funds within easy reach of the Bank's right of a set-off." (A. 40). But there were no judgment creditors of Oakland who were in a position to attach St. Clair funds (A. 33). Moreover, only one suit was pending against Oakland (to recover $1,600.00) and that was filed in January, 1971, three and one-half months before the beginning of the substantial build up.

First National Bank of Glen Head, of course, had full knowledge of the character of the activity in Oakland's account with it. Famighetti admitted observing the build up himself (A. 137) and the Bank knew how few withdrawals were being made on the account, knew the nature of at least some of those withdrawals, since most were to pay interest to the Bank itself, and knew that such was not the pattern of an ordinary business account.

On June 29, 1971, Brede called Famighetti to tell him that Oakland was in financial trouble, and that he was going to call his other creditors and try to work his way out (A. 169-174, 191, 192, 28). Famighetti immediately placed a freeze on Oakland's account, barring all withdrawals (A. 176, 177). The next day, on June 30, 1971, the defendant, First National Bank of Glen Head, set off the sum of $108,783.91 and applied it against the outstanding loan balance of Oakland in the amount of $125,000.00.

Oakland Foundry was adjudicated a Bankrupt on August 18, 1971, pursuant to an "Involuntary" Petition which was filed against it on July 15, 1971, just two weeks after the Bank set off the funds in the account against Oakland's outstanding debt (A. 5).

The District Court's Decision.

The District Court, in allowing defendant Bank's Motion for Summary Judgment in the Trustee in Bankruptcy's suit to set aside the set-off, assumed that at the time of the set off, Oakland was insolvent and that the Bank had reasonable grounds to believe that Oakland was insolvent. The Court further recognized that the set off was for the benefit of the creditor, was on account of an antecedent debt, was made within four months of bankruptcy, and enabled the Bank to obtain a greater percentage of its debt than other creditors of the same class. The Court held, however, that there was no transfer within the meaning of 11 U.S.C. § 96, since there was no evidence "to show any complicity by the Bank" in Brede's scheme to make these funds available for a setoff in the event of impending bankruptcy.

The Court held that in determining whether the monies deposited in the Bank were built-up in the regular course of business, the proper test is only whether the deposits were accepted by the Bank in the regular course of its business. Whether the deposits were made in the regular course of the Bankrupt's business, or whether they were made in the regular course of business between the Bank and the Bankrupt were held not relevant by the District Court.

The Trustee appeals. No cross-appeal has been taken as to the District Court's assumptions respecting Oakland's insolvency and the Bank's grounds for believing Oakland to be insolvent.

ARGUMENT

I

The Court may look to the Bankrupt's ordinary course of business in determining whether a transfer has been made within the meaning of the Bankruptcy Act.

In granting defendant's Motion for Summary Judgment, the District Court "assumed that the deposits were *not* made by Oakland in the ordinary course of its business, but were instead made either to isolate funds from its Illinois creditors, or to place funds within easy reach of the Bank's right of a setoff, which, if exercised, would reduce Brede's potential liability on his personal guarantee to the Bank." (A. 40). The Court further assumed that the Bank, at the time of the setoff "had reasonable grounds to believe that Oakland was insolvent." (A. 37). It was uncontradicted that Oakland had ceased to be an ongoing business concern in March of 1971, when it stopped meeting its payroll, and reduced its operations to a barebones office staff. (A. 15).

On these facts, it was error for the Court to conclude:

> "The test is not whether the deposits were made in the depositor's regular course of business, but instead, whether they were accepted by the Bank in its regular course of business." (A. 40).

In fact, no case has held the regular course of business requirement to be applicable solely to the Bank, and the authorities are numerous that a showing of a transfer within the meaning of the act is made where the Bankrupt's intention is shown to be to effect a preference, where, as here, at the time the deposits were made, the Bank knew of the depositor's insolvency.

The general rule is that a bank's set-off may be attacked as a voidable preference if the Bankrupt deposited the funds in question other than in the ordinary course of its business, intending a transfer, and the bank had reason to know, at the time the deposits were made, that the depositor was insolvent.

In *Mayo v. Pioneer Bank & Trust Company*, 270 F. 2d 823 (5th Cir. 1959), the bankrupt had borrowed $10,020.00 from the bank. The bank took a pledge agreement as security for the loan, the bankrupt pledging the balance due on a contract it had with the Federal Government. The Government was not notified of the pledge, and twelve days after the pledge agreement was entered into, the Government made a payment of $11,693.18 to the bankrupt on the contract. The bankrupt deposited the monies in its account with the bank. The bankrupt then directed the bank to enter a debit memorandum against its account in the amount of $10,020.00 to repay the loan, which repayment was made. All these transactions occurred within the four-month period prior to the filing of the Involuntary Petition in Bankruptcy against the Bankrupt. Finding a voidable preference, Judge Wisdom stated:

> "In *Cusick v. Second National Bank*, 1940, 73 App. D.C. 16, 115 F.2d 150, in which the bank set off a debtor's deposits of funds that were paid pursuant to two construction contracts against two loans made by the bank, the court said that the trustees could attack the setoff as a voidable preference if: (1) *at the time of the deposits either the company or the bank intended them to operate as payment of the debt rather than as an ordinary deposit* subject to the depositor's withdrawal; (2) at the time of the deposit, the depositor was in fact insolvent; and (3) the bank had reasonable cause to believe the depositor was insolvent at that time." 270 F. 2d at 836. [emphasis supplied]

The *Cusick* Court, relied upon by the Fifth Circuit in *Mayo*, recognized that a deposit made in similar circumstances would

not be a preferential transfer only "if both depositor and the bank intend" that it would be subject to withdrawal, 115 F.2d at 152, Note 4. In the present case, the District Court itself recognized that Oakland intended to facilitate the Bank's set-off, and did not intend to withdraw the funds.

In *Frankford Trust Co. v. Comber*, 68 F.2d 471 (3d Cir., 1933), where a bank, which was the creditor of an insolvent and subsequently bankrupt individual depositor, set-off funds from the depositor's corporate account which funds had been, at various times, transferred from the depositor's personal account to the corporate account, such funds being sufficient to satisfy the depositor's personal debt, it was held that a preference had been effected. The Court there stated:

> ". . . it seems almost self evident that Baseman with the consent and knowledge of the corporation was 'building up' the account so that it would be available at the proper time to meet the note. Cases where this is done form a well recognized exception to the rule of *New York County Nat. Bank v. Massey, supra.* See *Matters v. Manufacturers' Trust Company*, (C. C. A.) 54 F.(2d) 1010, 1013. In such a case Judge Learned Hand points out, *'It was enough that the depositor alone intended not to use his right of withdrawal until the bank's right ended it. The deposit becomes a transfer because the depositor means it to be such;* that is, he means not to exercise his right of withdrawal as to all of it, but to leave some part until that right is gone. It is not necessary that the residue shall be determinable in advance; no more need appear than that some part shall be left. When this is so the deposit is not in ordinary course; the part unused becomes a preferential payment when seized by set-off.'" *Frankford Trust Co. v. Comber*, 68 F.2d 471, 472 (3d Cir., 1933). [Emphasis supplied.]

A clearer recognition of the fact that it is to the intention of the depositor, to his ordinary course of business, and not the course of the bank's business, is difficult to imagine.

This rule was repeated in *Hood v. Brownlee*, 62 F.2d 675 (4th Cir., 1933), where the Court held:

> "If the Bankrupt himself had made the deposit with a view of giving the bank a preferential payment on its claim, the bank would not have had the right of set-off." 62 F.2d at 676.

In *Citizens National Bank of Gastonia v. Lineberger*, 45 F.2d 522 (4th Cir., 1930), the Court expressly recognized that in order to be deemed a bona fide deposit and not a transfer, where the bank has exercised its right of setoff, it is necessary that the depositor make the deposit in good faith, and that where such motivation does not appear in the depositor, a preferential transfer may be found.

> "But if the deposit is in reality a deposit, made in good faith as such . . ." 45 F.2d at 528.

Similarly, at 45 F.2d 531, using the disjunctive "or", the Court summarized:

> ". . . deposits in a bank in ordinary course of business in the absence of collusion or fraud, or some showing that they were made for the purpose of giving security or effecting a preference, are not to be deemed transfers."

The Court there recognized that it is the intent of the depositor which may be sufficient to make a "deposit" into a transfer and that the intent of the Bank is not necessarily the critical element.

There is no suggestion that Oakland, the Bankrupt, made the deposits in question in good faith here; indeed, the District Court

assumed that they were not so made and that they were intended by Oakland to effectuate a set-off.

The Fourth Circuit itself recognized the importance of the distinction it drew in *Lineberger* in *Bank of Commerce & Trusts v. Hatcher*, 50 F.2d 719 (4th Cir., 1931), where the Court, after quoting its earlier opinion at length, stated at 720:

> "But after stating that deposits made in regular course of business might be set off even though made when the bankrupt was known to be insolvent, we distinguished the case of deposits made otherwise than in regular course of business, as where made for the purpose of giving the bank a preference, or where made as payments and not for the purpose of creating a balance subject to check."

Thus, the opinion in *Hatcher* expressly recognizes that a deposit made with the intention that it be used as a set-off, regardless of the intent of the bank at the time of the deposit, is not made in the ordinary course of business and may be a voidable preference.

In the leading case of *Studley v. Boylston National Bank*, 229 U.S. 523, 527, 57 L.Ed. 1313, 1316 (1913), in finding no preferential transfer, the Supreme Court recognized that it is the intention of the depositor alone which may create a voidable preference:

> "We find nothing in the record to indicate that the deposits were made for the purpose of enabling the bank to secure a preference by the exercise of the right of set-off. The case, therefore, comes directly within the decision in *New York County National Bank v. Massey*, 192 U.S. 138, 48 L.Ed. 380, 24 S.Ct. 199 . . ."

The test was articulated by the Court in *McGuigan v. Deine Bank Title & Trust Co.*, 47 F.2d 760 (1931), wherein is stated, at 762:

> "The right of set-off is given by the Bankruptcy Act itself, and the test in cases where the right of set-off by a bank is questioned is always whether, after insolvency, the money was deposited for the purpose of enabling the bank to secure a preference. If not, the set-off should be made."

Again, the Court looks not to the intent of the Bank in accepting the deposit, but to the purpose in making the deposit.

In *Goldstein v. Franklin Square National Bank*, 107 F.2d 393 (2d Cir., 1939), the Trustee in Bankruptcy of a retail merchant brought suit against the bank to recover for preferences given by the bankrupt to the bank. The Complaint charged that the bankrupt, being indebted to the bank for $1,000.00 in promissory notes, made deposits of $1,000.00 with the bank, intending that they be applied as payment of the debt. The Complaint further alleged that the bank did apply the deposits as payments of the debt, that the bankrupt was insolvent at the time he made the deposits, and that the bank knew or had reasonable cause to believe that the bankrupt was insolvent at that time. There was no allegation that the bank was a party to a fraud. Similarly, there was no allegation that at the time the deposits were made, the bank knew that they were intended to constitute a preferential transfer.

The Court stated, at 394:

> "The cause of action alleged against the bank was that deposits made by the bankrupt between December 15th and December 27th, although made in his checking account, were intended to be used and were in fact used to pay off an antecedent debt of $1,000 owed by the bankrupt to the bank, this at a time when the bankrupt was insolvent, within four months of bankruptcy, and when the bank had knowledge or reasonable cause

> to believe that payment of the debt would give it a preference over other creditors. If these allegations were true, the deposits were voidable preferences under section 60 of the Bankruptcy Act, 11 U.S.C.A. §96."

The fact that in *Goldstein* the evidence proved that the Bank intended to apply the deposits as a set-off at the time the deposits were made was not pivotal in the Court's reasoning, and it is submitted, given this Court's own language stating what needed be proven to establish a voidable preference, that the same result would have been reached without the presence of that fact.*

The Circuit Court of Appeals for the Fourth Circuit, in *Joseph F. Hughes & Company v. Machen,* 164 F.2d 983 (1947), cert. denied 333 U.S. 881, 92 L.Ed. 1156, 68 S.Ct. 912, had before it a related problem. The bankrupt was in the construction business during the war, performing work on Government projects. Solvency of the bankrupt depended upon the validity of certain claims which it had against the Government. Upon being advised of doubts respecting the soundness of the bankrupt's claims against the Government, the First National Bank of Baltimore called its notes, and immediately took over the deposits of the bankrupt in the amount of $53,886.29, crediting this amount against the notes. The Baltimore National Bank did the same with respect to the bankrupt's deposit of $14,628.76, applying that amount against a note of the bankrupt for $25,000.00 which was due that very day. In the course of affirming a compromise between the Trustee and several creditors, the Court had the following to say:

> "Of course the application of these principles presupposes that there has been a bona fide deposit made in due

---

* On remand, the District Court concluded, inter alia, that the bank did not have reasonable cause to believe and did not know that the bankrupt was insolvent at the time of the transactions. *Goldstein v. Franklin Square National Bank* 31 F.Supp. 66 (N.Y. 1940).

course of business. Thus *where there has been a deliberate building up of an account for the purpose of enabling the bank to obtain a preference, or* where the deposit is accepted by the bank with the intent of applying it to the depositor's obligations rather than subjecting it to his power of withdrawal, an attempt on the part of the bank to set off the deposit will result in a preference as long as the other conditions of Section 60 are satisfied. *Rector v. Commercial National Bank*, 200 U.S. 420, 26 S.Ct. 294, 50 L.Ed. 533; *Mechanics' & Metals National Bank v. Ernst*, 231 U.S. 60, 34 S.Ct. 22, 58 L.Ed. 121; *Goldstein v. Franklin Square National Bank*, 2 Cir., 107 F.2d 393; *Twentieth Street Bank v. Gilmore*, 4 Cir., 71 F.2d 594; *Callaway v . West Palm Beach Atlantic National Bank*, 5 Cir., 69 F.2d 224, 225; *Frankford Trust Co. v. Comber*, 3 Cir., 68 F.2d 471; *Rupp v. Commerce Guardian Trust & Savings Bank*, 6 Cir., 32 F.2d 234. This result is reached because the apparent deposit is in fact a payment to the bank and the bankruptcy court will look through form to substance and treat the deposit as a transfer of property for or on account of an antecedent debt. *Mechanics' & Metals National Bank v. Ernst*, 231 U.S. 60, 34 S.Ct. 22, 58 L.Ed. 121; *Frankford Trust Co. v. Comber*, 3 Cir., 68 F.2d 471; *Matters v. Manufacturers' Trust Co.*, 2 Cir., 54 F.2d 1010." 164 F.2d 987, 988. Cert. denied 333 U.S. 881. (Emphasis supplied.)

The Court's language, in using the disjunctive "or", makes explicit that to find a preferential transfer, it is only necessary that the build-up be made by the depositor for the purpose of effecting a set-off, and that it is not necessary to show the complicity of the bank. Carefully distinguished by the Court is the intention of the bank at the time the deposits are made.

In the instant case, the Trial Court assumed that the Bank knew Oakland to be insolvent at the time the deposits were made. This, coupled with Oakland's intention at the time the deposits

were made, was sufficient to allow a finding of a preferential transfer.

Blue v. Herkimer National Bank, 30 F.2d 256 (2d Cir., 1929), involved a situation where twenty days prior to the bankruptcy, a special bank account was opened which was used for depositing all monies obtained as a result of state highway road construction contracts. Certain other monies obtained from sale of various items were also placed in the special account. In a two and a half week period, $14,415.33 was placed in the account. The bankrupt was indebted to the bank in which the funds were deposited on certain notes. This Court stated:

> "It is obvious that the monies thus collected were used for the purpose of creating a fund to be applied upon the maturing note obligations of the bankrupt during the four-month period, and this was a voidable preference, if the defendant had knowledge of the bankrupt's insolvency. *Mechanics' & Metals National Bank v. Ernst*, 231 U.S. 60, 34 S.Ct. 22, 58 L.Ed. 121, *In re: Starkweather and Albert* (D.C.) 206 F. 797. It had full knowledge of the bankrupt's financial condition from the statement furnished, and from its method of handling his monies when received in payment of the contract it displayed a desire to protect itself. To a considerable extent, the defendant took supervision of his finances in carrying out his contract. It has reasonable cause to believe that it was obtaining an advantage over other creditors, and it is chargeable with the intent of creating a preference for itself. *Alexander v. Redmond*, (C.C.A.) . . . 180 F. 92; *Gray v. Breslof*, (D.C.) 273 F. 526. Of this $12,312.64 received by the defendant after January 15, 1918, in the 'Robert Earl Special Account,' and which was not paid to the bankrupt, the defendant is responsible to the trustee."

This Court recognized in *Blue* that it is the bank's knowledge of its depositors' insolvency that is the crucial element of knowl-

edge on the part of the bank in determining whether there has been a voidable preference given. The fact that a special fund was present in *Blue* does not alter this, and the opening of this special account was certainly no more obvious than was the remarkable build-up in Oakland's account which was observed by Famighetti, the Bank's President, himself.

With respect to the Bank's "state of mind", in accord that it is knowledge of, or reasonable cause to know of, the depositor's insolvency, coupled with the depositor's intent, rather than the Bank's intent at the time of the deposits respecting that transfer, that is crucial, see *Saperstein v. First Security Bank of Utah*, 24 Utah 66, 465 P.2d 546 (1970); *Mayo v. Pioneer Bank & Trust Co.*, 270 F.2d 823 (5th Cir., 1959); *Cusick v. Second National Bank*, 115 F.2d 150 (D.C. Cir., 1940); *In re Almond-Jones Co.*, 13 F.2d 152, 157 (1926), affirmed sub nom. *Union Trust Co. v. Peck*, 16 F.2d 986 (4th Cir., 1927); *Studley v. Boylston National Bank*, 229 U.S. 523, 57 L.Ed. 1313; *Goldstein v. Franklin Square National Bank*, 107 F.2d 393 (2d Cir., 1939).

Indeed, even in one of the cases relied upon by the District Court, *Farmers Bank of Clinton, Missouri v. Julian*, 383 F.2d 314 (8th Cir., 1967) cert. denied 389 U.S. 1021, 88 S.Ct. 593, 19 L.Ed.2d 662, the Court, in finding no voidable preference, looked to the banking practices and daily business operations not of the Bank, but of the depositor.

> "The pattern of deposits and withdrawals throughout the month is fairly uniform and is certainly in line with the normal business operations of the bankrupt." 383 F.2d at 325.

In sum, the District Court applied an overly restrictive test respecting the ordinary course of business requirements of the test for determining the validity of a bank's set-off. The record is undisputed that a deliberate build-up had been made in Oakland's account with Glen Head. The Court properly assumed

that Oakland intended to build the account up in preparation of a set-off and did not deposit the funds in the regular or ordinary course of its business, that Oakland was insolvent at the time, and that the Bank had reasonable grounds to believe Oakland to be insolvent. What the Bank may have intended by acceptance of the deposits, and whether such acceptance was made in the ordinary or regular course of the Bank's business is of no importance. That the deposits were not made in the ordinary course of Oakland's business, and were accepted by a bank which had reason to know of Oakland's insolvency, is sufficient to classify them as preferences under the law. Summary Judgment for the Bank was therefore improperly entered.

II

It was error to grant defendant's Motion for Summary Judgment as a material issue of fact is presented by this record, whether the Court looks to the Bankrupt's or the Bank's ordinary course of business in deciding whether a prohibited transfer has been made.

The elements of a voidable preference under the Bankruptcy Act are: (1) a transfer of the debtor's property; (2) to or for the benefit of a creditor; (3) for or on account of an antecedent debt; (4) while the debtor is insolvent; (5) within four months of bankruptcy; (6) which enables such creditor to obtain a greater percentage of his debt than some other creditor of the same class; and (7) such creditor has reasonable cause to believe that the debtor is insolvent at the time of the transfer. *Kenneally v. First National Bank of Anoka,* 400 F.2d 838, cert. denied 393 U.S. 1063, 89 S.Ct. 716, 21 L.Ed. 2d 706 (8th Cir., 1968).

In granting the defendant's Motion for Summary Judgment, the Trial Court correctly assumed all of the elements numbered 2 through 7 to be present in the instant case.

The Bank certainly had reasonable cause to believe Oakland to be insolvent at the time the deposits were made and the District Court correctly assumed that at the time the transfers were made, Oakland was insolvent. The Bank had long been aware of Oakland's financial difficulties. Oakland had regularly provided the Bank with financial statements reflecting its adverse circumstances. The Bank had recognized Oakland's inability to timely pay the time note, and had accordingly converted the $125,000 Note to a Demand Note. The Bank was sufficiently concerned with Oakland's financial standing to demand a second mortgage on Brede's home as supplemental security in addition to the stock already pledged and the personal guarantee already made. The Bank knew that Oakland operated on a continuing loss basis, and knew that Oakland had a cash flow problem and had a low level of working capital. The Bank knew Oakland's debts, including those to the Small Business Administration were too heavy for it to carry, and knew that Oakland had obtained all the loans it could from the St. Clair National Bank in Belleville. The Bank knew how little money Oakland kept in its Glen Head account. The Bank also was aware that Oakland had falsified its 1970 Dun & Bradstreet Report. (A. 108, 109, 150, 115, 116, 128, 129, 122, 126, 130, 132, 133, 138, 139, 164, 165).

By accomplishing this set-off, the Bank was enabled to obtain a greater percentage of Oakland's debt than other creditors of the same class. This is undisputed, and the Bank, in the District Court, recognized it as such in its reliance upon cases which state that under certain circumstances not present here, where a bank sets off its depositors' funds, this is not an impermissible consequence.

The build-up began 2½ months before the set-off, and three months before bankruptcy. This was clearly within the statutory four month limitation.

The Bank was clearly a creditor of Oakland's, and benefited by the build-up and set-off, and the deposits were made with the Bank.

Prior to deposit, the set-off funds were undisputedly the property of Oakland, thus the sole remaining question is whether either the deposits or the set-off constituted a "transfer" of that property within the prohibition of the Act.

As plaintiffs have shown above, a preferential transfer will be found where the bank deposits made are not made in the ordinary course of the depositor's business. And the deposits made by Oakland were, as the District Court correctly recognized, not made in the ordinary course of Oakland's business. Indeed, by the time the Bankrupt began the buildup here challenged, it was virtually out of business. One month before the build-up began, in March, 1971, Oakland severely cut back its payroll; and the month it commenced the build-up, April, 1971, the factory had ceased to be a going concern and the office staff had been cut back. The next month, a second round of cutbacks was made in the office payroll, the factory having ceased operations the previous month. Several Courts have recognized that bank deposits made after a factory or business has ceased its operations are not made in the regular or ordinary course of business. *Merrimack National Bank v. Bailey*, 289 F. 468 (1st Cir., 1923); cert. denied 263 U.S. 704, 44 S. Ct. 33, 68 L.Ed. 515; *Gates v. First National Bank of Richmond*, 1 F.2d 820 (D.C., Va., 1924); *Wilson v. Nebraska State Bank*, 126 Neb. 168, 252 N.W. 921, 24 Am. Bankr. Rep. N.S. 621 (1934). In the *Wilson* case, an Involuntary Petition in Bankruptcy was filed, the company was adjudged bankrupt, and the Trustee in Bankruptcy brought suit against the bank for $9,745.93, which the bank had charged to the company's checking account one month prior to filing of the Bankruptcy Petition. The bank credited the $9,745.93 to the obligation owed by the company to the bank on a $16,250.00 Demand Note. The Court recog-

nized that at the time the set-off was made, the business had ceased to be a going concern. It held that the deposit made one month prior to the bankruptcy "was not made in the due course of business, that the defendant was not entitled to set off such deposit, or any part thereof, against the indebtedness due it from the company, and the act of the defendant in crediting $9,745.93 of such deposit upon the note of the company was a 'transfer' within the meaning of the Bankruptcy Act." Accordingly, the Supreme Court reversed the Trial Court's decision, and instructed it to enter judgment in favor of the Trustee in Bankruptcy.

The District Court correctly assumed that the reason Oakland instituted the build-up with the Glen Head Bank was to protect Brede, since Brede had personally guaranteed the obligation, had pledged all the stock in his several companies to the bank as security on Oakland's loan, and since Brede had further mortgaged his home to the Bank to secure the loan. Protection of a corporate officer's private finances is by no means a business practice recognized as being in the ordinary course of business.

There was sufficient evidence that the build-up was not made in the ordinary course of Oakland's business to make it a jury question whether a preferential transfer was made, either by Oakland in depositing over $108,000 in 2½ months in its previously inactive checking account, or by the Bank in setting-off the funds in the Glen Head account. Summary Judgment was, therefore, improperly entered.

Furthermore, even if this Court concludes that the District Court applied the correct test, namely, that it is the ordinary course of the Bank's business that provides the appropriate legal standard, plaintiffs submit that there was sufficient evidence to establish that these deposits were not accepted in the ordinary course of the Bank's business to send the question to the jury.

The set-off was not made until after the bank had forbade payment on checks in the account. Under the rule announced in *Mechanics & Metals National Bank of City of New York v. Ernst*, 231 U.S. 60, 34 S.Ct. 22, 58 L.Ed. 121, the Bank could not, after stopping withdrawals from the account, exercise its right of set-off. The *Ernst* case was followed by this Court in *Irving Trust Company v. The Bank of America National Association*, 68 F.2d 887 (2d Cir., 1934), an action by the Trustee in Bankruptcy of a stock and bond dealer against The Bank of America National Association to recover certain alleged preferential payments. The dealer's Voluntary Petition in Bankruptcy was filed July 3, 1930. On the afternoon of July 2, the dealer made a deposit in its account with the defendant bank, and $82,156.58 of that deposit was applied to the payment of a "day loan" which the bank had granted earlier on the 2nd of July. As to $3,894.58 of that amount, the Court concluded that a voidable preference had been created:

> "There is nothing to indicate that the defendant had a lien or claim against any specific property of the bankrupt which was released by the payment to defendant of this sum of $3,894.58. As to this amount, it was in the position of a general unsecured creditor; and it had no right of set-off because the deposit was received after it had reason to know of the bankrupt's insolvency and after it had forbidden withdrawals from, or certifications against, the bankrupt's account. *Mechanics & Metals National Bank of City of New York v. Ernst*, 231 U.S. 60, 34 S.Ct. 22, 58 L.Ed. 121." 68 F.2d at 890.

Here, there was evidence showing that the Bank had been in regular contact with Brede during the months immediately prior to the set-off, and that during that few months, the Bank was concerned about its money (A. 16, 17).

The Bank will, of course, argue that it was in the business of accepting money for deposit in its accounts, and that Oak-

land was merely acting like its other depositors in tendering those funds for deposit. This disregards the comprehensive knowledge that the Bank had of Oakland's financial straits, and also disregards the Bank's part in the build-up of Oakland's account. Though admittedly aware that a build-up was being made, the Bank, if the testimony of its President is to be believed, remained mysteriously silent, Cheshire cat-like, while the account was quickly built-up from $865.09 to $109,587.16. There is little more that the Bank could have done, without leaving indelible ink footprints, to participate in setting up the fund in this account.

Adopting the Bank's argument that it was merely accepting the funds in the ordinary course of its business will make it impossible ever to succeed in voiding a bank's set-off, for the simple reason that banks are ordinarily in the business of accepting money for deposit.

Oakland's Glen Head account was in reality further security for the $125,000.00 loan, and not a regular business account. The account was opened as a requirement to allowance of the loan. When Glen Head learned that there were other substantial creditors in the picture, it demanded increased security in the form of compensating deposits which bore a relationship to the size of the loan. The account was not used for routine business transactions. Indeed, during the 2½ months that the account was built-up, no checks were written on the account. There were only five transactions through the account during the eight months prior to the build-up, three of which were payments of interest to Glen Head.

After building the account up as much as he was able, on June 29, 1971, at about noon, Brede called the Bank. The Bank's memo records the conversation:

> "Said sorry he had to tell me by telephone—but things were not good out there—is gathering all his forces and

> meeting with people he's doing business with and owes money to. Has been out here almost permanently for the past month or so trying to determine just where he stood. Has moved in no direction at all—had to take a hard look at things and final [sic] came to the decision to meet with all people involved—is letting 'you know now by pone [sic]'." (Doc. No. 33, Exhibit I).

What Brede was rather obviously letting the Bank know was that no more money could be expected for the build-up, and that it was now time to move on the set-off. This, of course, the Bank did.

Had Brede, in his phone call to Famighetti on June 29, directed him to transfer the funds from Oakland's account to the Bank's credit, there would be no question but that a preferential transfer had been made. Similarly, had Brede written a check to the bank on the obligation and had the Bank credited that check to Oakland's account, there would unquestionably have been a preferential transfer. Plaintiff submits that the phone call advising Famighetti that he was taking a hard look at things and meeting with all persons involved, when seen in light of the build-up and the loan-guarantee-mortgage relationships between Brede and Famighetti, constituted, in effect, just such an order to transfer funds. It is to place form above substance to conclude otherwise.

Was it the normal and ordinary course of the Bank's business to accept for deposit such large sums in inactive accounts which earned no interest for their depositors, particularly where, as here, such large sums appeared quite suddenly in accounts with previously negligible balances?

Plaintiff-Trustee submits that the Bank would not have allowed any withdrawals to be made from the account and that a prohibited transfer was made every time a deposit was made into Oakland's account. Alternatively, if this Court adopts the

reasoning advanced by the Bank in the District Court, to the effect that Oakland retained control over the funds and could have withdrawn them at his pleasure, then it may be concluded that the act of crediting the deposits to the note of Oakland, after the phone call from Brede, and after payment had been ordered stopped on the account, was itself the prohibited transfer. *Wilson v. Nebraska State Bank, supra.* The consequence was the same under either theory: to transfer funds of Oakland to First National Bank of Glen Head, preferring the Bank to Oakland's other creditors of the same class.

Plaintiff-Trustee submits that even under the test enunciated by the District Court, that it is to the ordinary course of the Bank's business that the law looks in deciding whether a preferential transfer has been made, that a material issue of fact is presented by this record respecting whether the deposits were made in the ordinary course of the bank's business. Accordingly, whichever test is adopted, it was error to grant the Bank's Motion for Summary Judgment.

CONCLUSION

The District Court adopted an incorrect test in determining whether the deposits made were a preferential transfer. And under either the test adopted by the Court or under the correct test, a material issue of fact was presented by this Record, making entry of Summary Judgment improper. Plaintiff-Trustee, therefore, prays that this Court will reverse and vacate the Order granting defendant's Summary Judgment, and remand this cause for trial.

Respectfully submitted,

JOEL A. KUNIN
DAVID J. LETVIN
COHN, CARR, KOREIN, KUNIN
and BRENNAN
412 Missouri Avenue
East St. Louis, Illinois 62201
(618) 274-0434
Attorneys for Plaintiff-
Appellant

and

MURRAY S. LUBITZ
KAZLOW and KAZLOW
111 Brook Street
Scarsdale, New York 10583
(914) 723-5300
Attorneys for Plaintiff-
Appellant

State of Missouri,
City of St. Louis. } ss.

Willie Brown, of lawful age, being duly sworn, upon his oath states that he did, on the 23rd day of February, 1977, place in the United States Post Office at St. Louis, Missouri, a package containing one printed copy of Appendix and two printed copies of Brief of Appellant in the following entitled cause:

IN THE

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

No. 76-7577

DONALD KATZ, Trustee in Bankruptcy of Oakland Foundry Company of Belleville, Illinois, Inc.,
Plaintiff-Appellant,

vs.

FIRST NATIONAL BANK OF GLEN HEAD,
Defendant-Appellee.

that the proper : was plainly addressed to the following party:

Messrs. Weil, Gotshal & Manges
767 Fifth Avenue
New York, New York 10022

Willie Brown
Affiant.

Subscribed and sworn to before me this 23rd day of February, 1977
I am duly authorized under the laws of the State of Missouri to administer oaths.
My Commission Expires Oct. 1, 1977

Richard W. Beck
Notary Public within and for the City of St. Louis, Missouri.

To be filed for

JOEL A. KUNIN
DAVID J. LETVIN
COHN, CARR, KOREIN, KUNIN and BRENNAN
412 Missouri Avenue
East St. Louis, Illinois 62201
(618) 274-0434
Attorneys for Plaintiff-Appellant
and
MURRAY S. LUBITZ
KAZLOW and KAZLOW
111 Brook Street
Scarsdale, New York 10583
(914) 723-5000